reduce the accrual amount by 15.3 percent, and a 4 percentage point reduction in the health care trend would reduce the accrual amount by 55 percent from what Pac Bell seeks in its direct case.[111] Were we to grant exogenous treatment based on these speculative and highly sensitive assumptions, the LECs would only have to beat those assumptions to realize an apparent productivity gain.[112]

66. In sum, given the flaws in the NERA and the Godwins studies, we cannot accept the LECs' conclusion that the majority of the costs associated with the TBO are not reflected in the GNP-PI. We have no means of accurately calculating the extent of the impact on the basis of the record. Rather, we are dependent on the LECs. They bear the burden of providing the Commission with accurate data. When such data are not forthcoming it is impossible for us to conclude with reasonable certainty whether and the extent to which the costs associated with the TBO are not reflected in the GNP-PI. Indeed, it would be arbitrary for the Commission to select a number based on the record before us.

b. Intertemporal Double-Counting

67. In addition to the reflection of OPEB costs in GNP-PI itself, this case presents a source of double-counting which we have not contemplated before. This source arises from the intertemporal nature of this change. Because pay-as-you-go amounts for OPEBs are already built into the LECs' rates, the "GNP-PI - X" factor in the PCIs would give the LECs all the funds they need over time to cover these expenses. Exogenous treatment of the movement forward of the recognition of expenses required by SFAS-106 thus introduces a second source of possible double-counting: the immediate recovery of these costs (on an accrual basis) as an exogenous change, and the recovery over time of these costs in the GNP-PI - X adjustments to the PCIs.

68. The LECs have attempted to remove this second source of double-counting by claiming as an exogenous adjustment only the difference between current pay-as-you-go amounts and their current estimate of the accrual amount. However, for this difference to accurately remove this form of double-counting, the assumed values of the medical trend growth rate, discount rate, retirement rates, and all the other demographic assumptions used to determine the accrual amount must exactly match what will occur, and must not change over time. If

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111 AT&T Opposition at 22-23. We are also concerned that the assumptions that are developed from these data, such as the medical trend rate we discuss here, can easily be manipulated and that even a small percentage difference in the assumption derived from the data can significantly affect SFAS-106 expense.

112 MCI Opposition at 10. Finally, some parties suggest that simply because there may be uncertainty and some double counting, these are not sufficient reasons to deny the entire exogenous amounts requested. Instead these parties suggest that the Commission reduce these amounts to the extent it believes such reductions are reasonable. The price cap rules, as well as Section 204 of the Communications Act, squarely place the burden on the carrier to demonstrate that the change at issue has a unique or disproportionate impact on the LECs. The LECs have not met that burden here.

the assumptions are incorrect or change over time, companies will have an apparent productivity gain (or loss) by beating (or not beating) the assumptions, rather than by becoming more efficient (or less efficient) than they were in the past. Thus, the accuracy of the assumptions is critical to prevent a shift of the risk/reward balance between carriers and ratepayers which was set up in price caps.

69. While it may be possible to make an informed estimate of what these assumed values currently are, it is not clear that we can determine what they should be in an economic sense. The removal of the intertemporal double-counting depends on the assumptions used being correct. We are not persuaded that we should make these estimates to protect the LECs from what we view as a normal business risk, of the sort that price caps places on the LECs. Additionally, a year-by-year true-up mechanism that would be necessary to deal with this double counting issue would be a complex addition to the price cap plan, especially since the price cap mechanism, without any exogenous adjustment, will permit LECs to recover all OPEB expenses over time.[113]

c. Other Double-Counting

70. It also appears very possible that the effect is double-counted in other components of the price cap formula. One instance is the rate of return used to establish reasonable initial rates to begin price caps. SFAS-106 does not change actual OPEB liabilities, but only the time at which they are recorded in company accounts, so as to better inform investors of the extent of the company's liabilities. How investors evaluated these liabilities for LECs and other companies before and after the adoption of SFAS-106 is unclear, especially since many companies have not yet calculated or reported the results. To the extent that investors based their assessments of risks and earnings on the accounts as filed, it remains uncertain how the risks to LECs were assessed.

71. For instance, if investors knew that the LECs would be unable to raise their rates upon implementation of SFAS-106, then the investors might require a higher return. Conversely, if investors knew that the LECs would be able to raise their rates upon implementation of SFAS-106, then the investors might accept a lower return. Investors, of course, did not know whether the LECs would be allowed to raise their rates upon implementation of the accounting change.[114] Thus, what investors believed about the effect on rates

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113 In view of our conclusion that the current record does not support exogenous treatment of SFAS-106 costs, we do not address AT&T's alternative proposal to limit such treatment of amounts actually funded and to specify the parameters of allowed accruals.

114 In the _LEC Price Cap Order_ we stated generally that no carrier could treat GAAP changes as exogenous until we approved the change. _LEC Price Cap Order_, 5 FCC Rcd at 6807. More specifically, the Commission deferred consideration of exogenous treatment of SFAS-106 until FASB had approved the change in GAAP, and the change became effective. _LEC Price Cap Reconsideration Order_, 6 FCC Rcd at 2663.

of this change determined what return they required on their investment in the LECs. There must have been at least some doubt about whether the LECs would be able to change their rates when SFAS-106 was implemented, and thus a relatively higher return would have been required. If so, the change to SFAS-106 would already be reflected in the initial rate of return. However, no party in this investigation has introduced evidence on what investors' expectations were and, indeed, it may not be possible to quantify this factor with any accuracy.

72. Finally, although not raised by the parties, we find that another unresolved double counting issue centers on the extent to which SFAS-106-type costs are included in the studies of cost changes used to determine the productivity factor in the price cap formula. The short run productivity study in Appendix C of the LEC Price Cap Order[115] examined changes in LEC costs from 1984 through 1990, adjusted for several exogenous cost factors. During this period, several LECs were introducing VEBA trusts.[116] These trusts were a method of prefunding the OPEB obligation for certain bargaining unit employees. No adjustment was made in the short run productivity study for these VEBA costs. The long run study of productivity, in Appendix D of the LEC Price Cap Order, which examined data from 1930 to 1989, also made no adjustment for these VEBA trusts. Thus, the productivity studies on which the Commission relied to set the productivity factor in the PCI formula already reflected some SFAS-106-type costs. There are thus two possible questions about double counting which must be considered, but that the LECs failed to address: (1) what would have been the effect on the productivity studies of excluding these

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115 5 FCC Rcd at 6885-6928.

116 VEBA Trusts are tax effective funding vehicles that generally forbid removal or transfer of funds except for the purpose for which they were established. 26 U.S.C. § 501(c)(a). Some LECs argue that it is unfair that some carriers were permitted to reflect in their rates OPEB accrual amounts funded in these VEBA trusts prior to implementation of the price cap system, but that other carriers would not be permitted to reflect these amounts if we reject their request for exogenous cost treatment. We note, however, that the LEC Price Cap Reconsideration Order made clear that we would not remove already-accrued OPEB expenses from initial price cap rates because to do so would redefine what is accepted as reasonable and prudent under prior, rate of return standards. LEC Price Cap Reconsideration Order, 6 FCC Rcd at para. 62. These amounts should not be treated as unreasonable or imprudent, we continued, merely because our regulations have changed. Id. As we stated previously, the initial PCIs of the LECs were set at existing rate of return levels as a reasonable, "rough justice," starting point for price cap regulation.

We also made clear at that time, contrary to the allegations raised by some of the parties in this proceeding, that we would not prejudge the issue of whether OPEB expenses should be afforded exogenous cost treatment. We did not conclude that exogenous cost treatment of OPEB expenses would necessarily follow from an effective FASB decision. Rather, we stated that "carriers that elected to wait until the GAAP change becomes effective before expending funds for OPEB are not necessarily foreclosed from recovering those costs." Id. (emphasis added).

costs, and; (2) how would the Commission have weighed this change in the results of the studies in setting the productivity factor.[117]

D. Reasonable Rates and the Operation of the Price Cap Plan

73. Our denial of exogenous treatment of SFAS-106 on the current record may be viewed by the LECs as unnecessarily strict. In our view, however, the result is not unfair to the LECs or to customers, and is consistent with the price cap plan. As we discussed above, the price cap plan was intended to create incentives similar to competitive markets by relatively simple administrative mechanisms. One of the major reasons for limiting exogenous factors was precisely to retain incentives and to minimize complexity. The list was also developed as part of the overall proceeding, subject to extensive public review and comment, where all potential exogenous changes could be considered, not simply those the LECs might choose to propose. Our approach to the overall design of the price cap plan struck a careful balance between the interests of carriers and ratepayers. If we were not to follow a strict approach to requirements for exogenous treatment, ratepayers would be at risk because the LECs would have incentives to make a case for exogenous treatment only when it raises the PCI, and not when such treatment would lower the PCI.

74. In addition, the implementation of SFAS-106 does not change the size or nature of the OPEB payments of LECs or other firms to their present or future retirees. These are matters of the firms' business decisions or their negotiations with employees and unions. As MCI points out, LECs are not required to change these payments in any way, but only to change the timing of the recognition of those costs on their books, to the extent that the LEC has not pre-funded its OPEB commitments. This accounting change should be useful to investors and management in evaluating company balance sheets. It may also prompt a reevaluation of OPEB benefits packages, based upon the clearer recognition of OPEB liabilities. But it does not change the actual flow of benefits payments the companies make over time. The LECs' actual OPEB payments will continue to be based on the terms of their benefit plans for current and future retirees, and the claims submitted by retirees under those plans. The price cap mechanism, since it is based on rates and costs as of 1990, already provides for recovery of these actual OPEB payments. It is thus the case that this GAAP change does not create an economic cost change for companies in general or for the LECs in particular, as the NERA Study also contends.

E. Conclusion

75. We believe our decision to deny exogenous treatment of the SFAS-106 accounting change at this time is fully consistent with the price cap plan system of regulation implemented in 1990. Price caps was designed by this Commission to create a simplified approach to setting fair rates with strong

117 Exclusion of these costs from the short run study would have resulted in a greater reduction in LEC costs in the period studied. The greater reduction in LEC costs would have implied a larger productivity factor in the short run study. If this were the case, the Commission might well have chosen a higher productivity factor for the price cap formula.

efficiency incentives. In a system where few costs can be passed through to rates, carriers are forced to manage their business operations, including personnel administration, to maximize efficiency. To avoid blunting of efficiency incentives, the price cap rules thus permit only a few types of costs to be treated as exogenous cost factors. Under the test we have established for costs such as those associated with GAAP changes, ongoing costs of LEC decisions regarding employee benefit programs are within the control of the LEC, as well as being reflected in GNP-PI, and thus do not qualify. The control issue may be less clear for the TBO amounts, but the LECs in the current investigation have in any event not met their burden of demonstrating that these costs will have a unique or disproportionate effect upon them.

76. Our decision in this case is not intended to foreclose further consideration of exogenous treatment of TBO amounts, based on a better and more complete record, for example in the annual 1993 access tariff filings. In addition, the issues identified in this proceeding concerning the role of exogenous costs in price caps may also be raised in the comprehensive review of price caps, scheduled to begin before the end of this year and to be completed by the end of the fourth year of the plan in 1994. In the mean time, the low-end adjustment mechanism provides substantial protection against prolonged unreasonably low earnings.

V. ORDERING CLAUSES

77. Accordingly, IT IS FOUND pursuant to Sections 4(i), 4(j), 201(b), 203, 204(a)(1), 403, and 404 of the Communications Act that the tariff rates in Bell Atlantic Tariff F.C.C. No. 1, Transmittal Nos. 497 and 536, US West Communications, Inc. Tariff F.C.C. Nos. 1 and 4, Transmittal No. 246, and Pacific Bell Tariff F.C.C. No. 128, Transmittal No. 1579 ARE UNJUSTIFIED AND UNLAWFUL.

78. IT IS FURTHER ORDERED that Bell Atlantic, US West Communications, Inc. and Pacific Bell SHALL FILE tariff revisions removing the unlawful material and reinstating lawful tariff material no later than seven days after the release of this Order to become effective on not less than one day's notice. For this purpose, Sections 61.58 and 61.59 of the Commission's Rules, 47 C.F.R. §§ 61.58, 61.59, ARE WAIVED, and Special Permission No. 93-85 IS ASSIGNED.

79. IT IS FURTHER ORDERED that the Bell Atlantic Telephone Companies, US West Communications, Inc., and Pacific Bell SHALL REFUND, WITH INTEREST, all new or increased charges collected as a result of the afore-mentioned transmittals to the persons in whose behalf such amounts were paid, no later than thirty days following the release of this Order.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy

Donna R. Searcy
Secretary